THE CAPITAL OBSERVER

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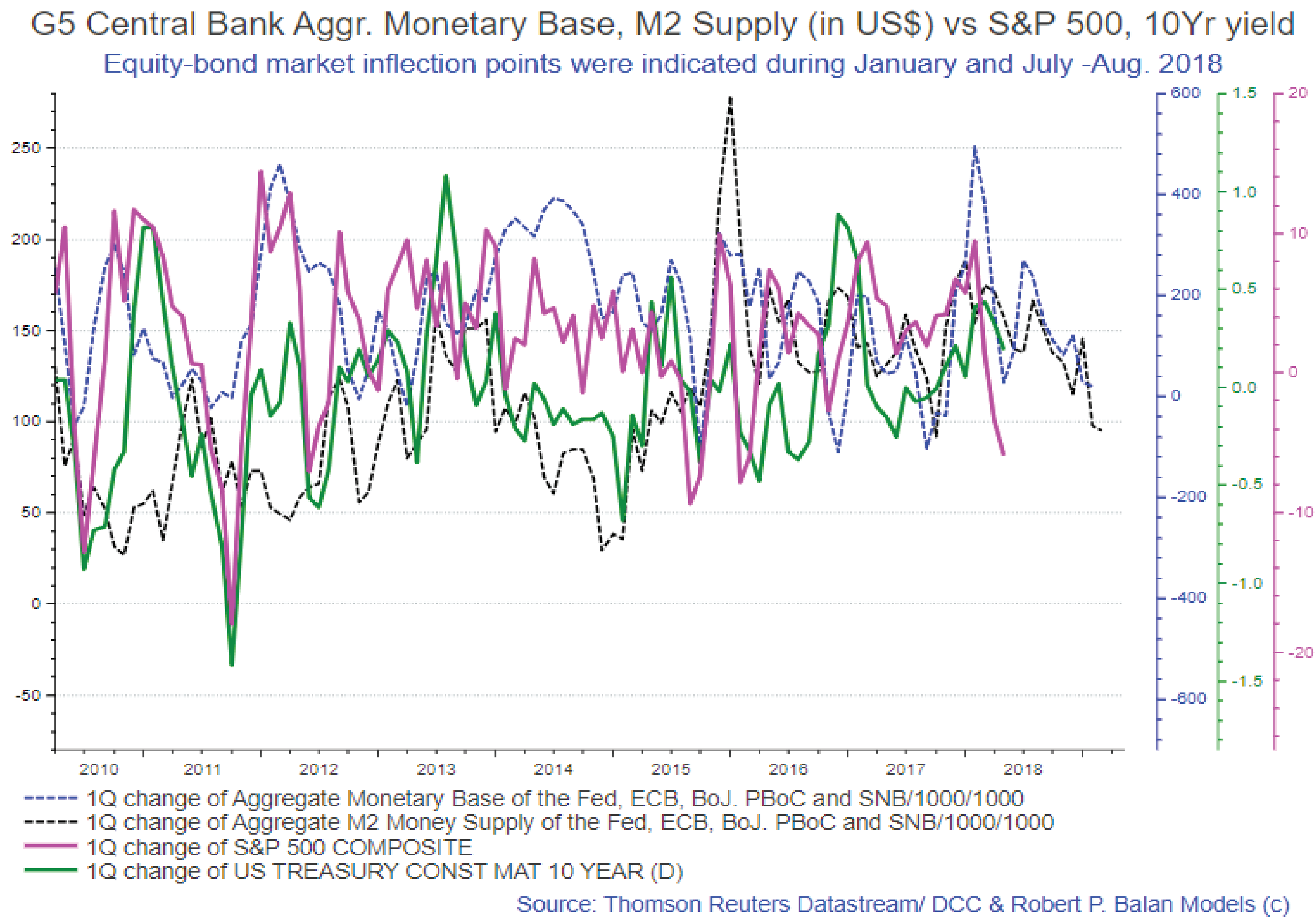
LIQUIDITY IMPACT on key Assets for 2018



At The Capital Observer, we look at **the liquidity being issued or being absorbed back by global central banks**, the Federal Reserve and the US Treasury (liquidity flows) and model the manner those real money balances impact asset prices.

The grand-daddy of systemic liquidity is, of course, the aggregate stimulus provided by the leading global central banks (the Fed, European Central Bank, Bank of Japan, People's Bank of China, and Swiss National Bank). Their aggregate balance sheets have been feeding the markets since late 2008. Due to their relatively large volume, the aggregate G5 central bank stimuli (in the form of bank reserves) have also become their de facto Monetary Base(MB). Due to the small percentage of the cash percentage (notes and coins) to the whole, banks reserves being held by central banks have become their MB. The aggregate global central 15 bank balance sheet has been credited with pushing up the valuation of equity markets around the world

After the US Federal Reserve launched its Quantitative Easing programs, major global central banks followed suit. The volume of the bank reserves generated in those large scale asset procurements were so large that for all intents and purposes those reserves have become the Monetary Base of the central banks of the US, the EU, Japan, China and the Switzerland. The impact of those aggregate global reserves on financial assets was enormous. Thereafter, financial assets have become beholden to the flow of that global aggregate systemic liquidity. The prices of financial assets have risen as the flow of the aggregate Monetary Base rose, and opposite is also true.

Of the global central banks, only the Fed is currently reducing its balance sheet. Therefore, if we take the aggregate balance sheet of central banks which have gone the way of Quantitative Easing (G5 – US, Japan, Eurozone, China, Switzerland), high frequency changes (flows) in the aggregate global central bank balance sheet will merely reflect the Fed's ongoing QT program at this time.
Already, the impact of the Fed's balance sheet reduction is being seen in the wobbly performance of risk assets, which are linked to the outflows we are currently seeing in US M2 Money Supply and the US Monetary Base. That is impacting the near future trajectory of asset prices

There is a long distributed lag between those liquidity flows and its direct impact on the financial assets, which is usually from 11 to 12 months long. In the graph provided above, for 2018, the flows peaked in January, which coincided with the peak in the S&P 500 Composite, and the 10-year US Treasury Bond Yield. There is another peak in the liquidity flow being shown in July – August, this year. We therefore expect financial assets to also make significant peaks at that time. We have added the aggregate M2 money supply of the 5 central banks (in terms of US Dollars) as control variable, as is also lagged 12 months. The M2 control variable as tends to peak or bottom in concert with the Monetary Base aggregate.